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The RAND Corporation, 1700 Main Street, P.O. Box 2138, Santa Monica, CA 90406-2138

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CHINA

1988 proved a trying and problem-laden year in China. Ten years after the leadership initiated far-reaching economic reforms and greatly expanded ties with the outside world, major complications were slowing the pace of reform, especially in the domestic economy. Efforts during the summer to initiate wage and price reforms led to rapid inflation in China's cities, prompting reimposition of stricter central economic controls. Repeated challenges to the authority of the Communist Party of China (CPC)--from dissident intellectuals, from university students, and in Tibet--called into question the Party's ability to guide the country's political and economic life. Notwithstanding these difficulties, the leadership strongly reiterated its commitment to continued reform, including further expansion of China's foreign economic relations and enhancement of the country's diplomatic profile. Relations with the Soviet Union improved substantially, while ties with the United States and Japan experienced uncertainty amidst general forward movement.

Domestic Affairs. The reinvigoration of China's reformist policies of the past decade dominated the leadership agenda during much of the year, but with uneven results. Deng Xiaoping, the 84-year-old architect of China's shift toward market-oriented socialism and away from ideologically based politics, continued his decade-long effort to bequeath power to a successor leadership. Zhao Ziyang, the 69-year-old former Premier who had been named CPC General Secretary in the fall of 1987, remained the leading exponent of reformist policies. Zhao focused

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on accelerating development of China's coastal regions, in particular through heightened emphasis on labor-intensive industries that were expected to generate increased foreign exchange earnings. In Zhao's estimation, a more aggressive, export-oriented development strategy would enhance China's access to foreign capital and technology and allow increased opportunities for foreign businessmen in the Chinese market.

A more cautious approach to change was advocated by the 59-year old Li Peng, a Soviet-trained engineer who succeeded Zhao in the Premiership of the State Council in April. Although a supporter of the broad goal of reform, Li was much more circumspect than Zhao in lobbying for change, and appeared more concerned about maintaining stability and continuity within the framework of central guidance and direction of the economy. Li was closely allied with veteran economic planner Yao Yilin, who also seemed noticeably more cautious than the major reform advocates in charting the nation's policy options. These leadership disagreements, however, did not approximate the bitter, highly factionalized political struggles of earlier decades, and instead reflected legitimate differences in emphasis and policy thinking at the upper reaches of the system.

Thus, Zhao's calls favoring the coastal regions in investment decisions and allowing these regions increased decisionmaking authority met with skepticism from other officials. Some leaders expressed growing concern that these policies would further skew China's pattern of economic development, with the interior regions lagging seriously behind coastal provinces in their rates of economic growth and in their access to imported technology. Others questioned Zhao's highly optimistic assessment of the country's ability to compete in international markets. The issue of increased local autonomy proved contentious both at a political and an economic level since the central authorities appeared to be relinquishing much of their capacity to direct and implement overall policy goals.

A second pillar of Zhao's policies involved the revamping of China's institutional arrangements. Despite the success of the reform program in spurring economic development, many observers had concluded

that the present economic and administrative structure was ill-suited to sustaining long-term growth. Zhao therefore stressed the necessity of additional steps to separate party and governmental functions, seeking to remove the CPC more definitively from its past economic management function at the same time that governmental authority over individual enterprises would be further restricted. The promulgation of an enterprise law was deemed crucial to these changes, since the law sought to separate ownership of state-run factories from the issue of managerial authority. Without such steps, reform advocates asserted, it would prove impossible to introduce genuine competition among the country's industrial enterprises or to provide meaningful incentives to encourage increased productivity.

A third pillar of Zhao's reform strategy concerned attainment of a stable social and political framework. The policy changes of recent years had unleashed new forces onto the Chinese political, economic, and intellectual scene, and many groups were more prepared than in the past to voice their grievances. These included intellectual dissidents dissatisfied with the opportunities for freedom of expression, Tibetans resentful of the control exercised by authorities in Beijing over their political and religious activities, and other social groups (especially in the interior) benefiting less fully from the prosperity generated by the economic reforms. During February and March, the disaffection assumed a variety of forms, some of it violent. Anti-Chinese riots in Tibet resulted in five deaths, as the police forcibly put down the protests. In June, university students in Beijing marched peacefully to protest the death of a fellow student, but in open defiance of warnings from the regime not to launch demonstrations. Chinese officials also acknowledged very sharp increases in the crime rate and in riots and illegal strikes in various locales.

Some of the largest challenges to maintaining social order concerned price control. Reform of China's irrational price structure had long been among the most sensitive issues on the reform agenda. However, the leadership remained very wary of abrupt actions in this area, especially after the inflation rate in 1987 approached 20 percent.

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Despite reservations and lingering anxieties expressed by other top leaders, Deng Xiaoping personally intervened as a forceful advocate of price reform. In May, price controls on meat, sugar, eggs, and vegetables were eased, and deregulation of cigarettes and alcohol followed in July. These steps led to panic buying of foodstuffs and consumer items and the most severe inflation in the regime's forty-year history.

In the wake of these developments, the leadership sharply shifted political course. In Politburo deliberations undertaken in August at the seaside resort of Beidaihe, price and wage reforms were effectively shelved for the near-term. According to Zhao, attention would instead focus on a longer-term restructuring of the economic framework as a whole, in particular reform of the enterprise system and development of the market mechanism. In a further retrenchment, the State Council announced that no additional deregulation would be undertaken during the remainder of 1988 or 1989, with stricter anti-inflationary policies to be adopted, as well. These measures were followed by a late September Politburo decision to curtail related reform measures.

Many observers interpreted these changes as a political setback for Zhao and a victory for Li Peng, since attention would now shift to slowing the pace of price reform, stabilizing the economy and rectifying the economic order--all goals with which Li was closely associated. Although Zhao's credibility and political position were damaged in the aftermath of these policy reversals, rumors that his Party post was endangered proved erroneous. Moreover, Deng reiterated his desire to scale back his political activities even further, asserting that Zhao and Li were now jointly responsible for the nation's political fortunes.

Thus, rather than engaging in an acrimonious policy debate, the leadership as a whole sought to forestall the most serious challenge to China's reform policies since their introduction a decade ago. This policy shift also included a major new assault on official speculation and corruption which had grown especially rampant in the past several years. Considered as a whole, the leadership hoped that the reimposition of greater central control would lead to a restoration of

popular support for the reforms, while instilling greater confidence in the government's ability to act decisively.

At the same time, Zhao and other leading reformers renewed their appeals to intellectuals, many of whom retained major suspicions of the government in the wake of the early 1987 crackdown on university campuses. Zhao repeatedly sought more active and enthusiastic involvement of highly educated youths in the reform process, given that their skills and technical knowledge were crucial to China's long-term prospects for scientific and technical advancement. The increased ability of leading dissidents, such as astrophysicist Fang Lizhi, to publicly air their views suggested an easing of earlier restrictions on freedom of expression. But the continued harsh attacks of Li and other intellectuals on CPC policy indicated a deep-rooted cynicism about the Party and its commitment to increased openness.

The Economy. The problems encountered in price reform reflected the complexity of shifting from a highly planned system toward a more mixed economy. The economy continued to grow at a very rapid pace, with industrial output increasing nearly 18 percent over 1987. But this rapid growth obscured underlying economic problems, including rapid increases in the money supply, raw material and energy shortages, uncontrolled expenditures for construction and consumption (especially at the local level), and an inflationary spiral that in most instances had wiped out growth in real income. The principal goal of policy, therefore, was to cool the overheated economy by curtailing capital construction and reducing money supply. Other measures included tentative steps toward issuing of stock shares in enterprises and even the commercialization of housing.

The policy changes of the past decade had greatly reduced the control of the central authority over the economy as a whole. Much of the recent economic growth had occurred outside the plan, with localities and enterprises increasingly able to make their own financial decisions, sometimes in defiance of the central authorities. Quite apart from measures to curb total demand and reduce the amount of money in circulation, there had already been a major devolution of authority

to different regions, with market forces proving increasingly decisive in the overall distribution and control of economic resources. The impact of this decentralization was greatest in China's southern provinces, where the links to the outside world were most fully developed. Decisions to curtail excessive investment initially aroused concern among foreign investors that numerous projects might be cancelled, but the new policies emanating from Beijing appeared unlikely to diminish these activities appreciably.

Economic uncertainties were also affecting China's foreign trade performance. Official data indicated that foreign trade would again reach record levels in 1988, with exports increasing nearly 15 percent over 1987 and imports increasing nearly 25 percent over the previous year. By year's end, however, officials were conceding that the overheated economy and the high inflation rate had altered plans for reform of the foreign trade system. The objective of the reform had been to increase the power of Chinese manufacturing and marketing organizations, thereby making them more responsive and adaptive in an increasingly competitive trading environment. But efforts to decentralize the foreign trade sector had led to numerous abuses by various local governments and import-export organizations, with profiteering and corruption rampant in many areas.

At the same time, inflation diminished investor confidence in the Chinese currency, with a growing gap between the official and unofficial exchange rates. China continued to resist calls for a devaluation of the yuan, largely because of its potential effect on the Chinese import bill. Although some officials claimed that China would enjoy a modest trade surplus for the year, other sources acknowledged a trade deficit of more than \$4 billion, with few expectations that this amount would narrow appreciably in the near future.

Some of the most unsettling consequences of recent economic changes occurred in agriculture. The agricultural sector has long been considered one of the principal success stories of the Deng Xiaoping era. However, for four consecutive years grain production has failed to

surpass the record of 407 million tons established in 1984. Declining prices for farm products, continued reductions in agricultural investment, fertilizer shortages, and the removal of arable land from crop production (often for new housing and rural industry) had impinged upon agricultural performance at the same time that population increases and changing dietary patterns placed new demands on the supply of foodstuffs. As a result, the rationing of pork, eggs, and sugar that was reinstituted in late 1987 continued into 1988, and China increased its large-scale grain purchases from abroad, acquiring more than seven million tons from the United States alone. Some officials (including Premier Li Peng) called for greatly increased infrastructural investment in the agricultural sector, but the prospects for provision of needed resources remained highly problematic.

A second long-term problem concerned the growing income disparities between China's interior and coastal provinces. The gap in development levels had long been recognized as a byproduct of the priority emphasis given to the coastal areas, but some leaders now seemed more prepared to acknowledge the extent of the problem. Expectations of a "trickle down" effect and of the provision of economic aid by more prosperous regions to poorer locales had yet to be met, especially with enhanced local control over economic resources. The existence of winners and losers in the Chinese developmental process remained a festering issue for which the leadership had no ready solution.

Foreign Affairs. China's leaders remained vigorous and active in pursuit of their twin goals of foreign policy independence and diminished regional tensions. Although Beijing's economic and technological links were oriented principally toward the United States, Japan, and other major developed powers, at a political level Chinese diplomacy was increasingly diversified and adaptable.

Some of the most notable developments during the year occurred in relations with the Soviet Union. Since the accession of Mikhail Gorbachev to top leadership in the Kremlin, both Moscow and Beijing had more actively pursued the possibilities for reduced tensions and expanded contact. The Soviet decision to withdraw its forces from

Afghanistan, a partial withdrawal of Soviet troops deployed near the Chinese border in Mongolia, and heightened diplomatic maneuverings on resolving the Cambodian conflict had a significant effect on Chinese thinking. At the same time, Gorbachev's increasing decisiveness at home and abroad helped convince Chinese officials (especially Deng Xiaoping, who has long remained distrustful of Soviet long-term intentions) that the new Soviet leadership was determined and sincere in seeking to improve relations.

The tempo of Sino-Soviet relations increased at all levels. A rapid expansion of trade relations had catapulted the Soviet Union into the ranks of China's top half dozen trading partners; two-way trade increased by at least one-third in 1988, and seemed likely to approach \$4 billion. Although infrastructural constraints inhibited an even more rapid expansion of these relations, both sides appeared intent on enlarging the scope of this cooperation, including increased border trade and a heightened Soviet role in refurbishing Chinese industrial enterprises. Conducting trade on a barter basis also proved beneficial, given the foreign exchange limitations encountered by both states.

However, movement at a political level attracted the most attention. In August, Moscow and Beijing conducted their first meetings explicitly focused on resolving the Cambodian conflict, with China urging the USSR to increase pressure on Vietnam to commit to an early withdrawal of all its forces. In October, Deng Xiaoping voiced his most optimistic assessment to date on the prospects for a full normalization of relations, indicating for the first time that a summit with Gorbachev was increasingly likely during the first half of 1989. With the exception of a hastily arranged meeting of the premiers of the two countries at the peak of Sino-Soviet border tensions in 1969, no such meeting had been held in thirty years. Thus, a Deng-Gorbachev summit was expected to signify the end of three decades of estrangement between the world's two leading communist states. To expedite movement toward a summit, newly appointed Foreign Minister Qian Qichen visited Moscow in December for discussions with his Soviet counterpart, Eduard Shevardnadze, as well as with Gorbachev. It marked the first visit of

China's senior diplomat to the Soviet capital since the 1950s. The two sides announced that Shevardnadze would pay a reciprocal visit to Beijing early in 1989.

Despite these developments, Chinese officials repeatedly emphasized that they were not pursuing improved Sino-Soviet ties at the expense of existing relationships, especially those with the United States. Sino-American relations, although encountering difficulties and tensions on political and economic issues, continued to develop. According to U.S. data, two-way trade in 1987 surpassed \$10.5 billion, and estimates for 1988 ranged as high as \$13.5 billion, second only to Japan. U.S. investment in China surpassed \$3 billion, more than any other country. Approximately 30,000 Chinese students were in the United States for advanced training, and increasing numbers of American students and teachers were now residing in China.

Disagreements in several areas, however, created uncertainties and tensions. China's increasingly active arms sale diplomacy in the Middle East and the Persian Gulf caused consternation among senior U.S. officials. Continued Chinese sales of Silkworm anti-ship missiles to Iran had created difficulties during 1987, but even greater concern was expressed by disclosure of Beijing's 1988 sales to Saudi Arabia of intermediate-range ballistic missiles (IRBMs). Although Chinese officials assured their American counterparts that there had been no transfer of any nuclear warheads, the proliferation of ballistic missiles into a highly volatile, heavily armed area sent reverberations throughout the region. During separate farewell visits to China by Secretary of State Shultz and Secretary of Defense Carlucci, both warned the Chinese of the destabilizing consequences of such transactions, which for a time seemed likely to limit future high technology transactions with Beijing. Especially after Mr. Carlucci's October visit, however, it appeared that the Chinese had given more definitive assurances about future restraints on such transactions.

The Chinese also sought to put relations with Japan on a more solid footing. There had been frequent tensions with Tokyo in recent years, with China voicing growing concern over the growth of the Japanese

defense budget and manifestations of what Beijing deemed excessive nationalism. Chinese officials had also complained repeatedly about Japan's unwillingness to more fully expedite the transfer of advanced industrial technology to China, and also had voiced concern about trade deficits with Tokyo, which in 1985 had reached \$5 billion. However, a major effort by Beijing to curtail imports from Japan had achieved substantial results, with China showing a surplus of approximately \$700 million through October 1988. Total trade for ten months was nearly \$16 billion, and it seemed likely that the final figure would approach \$20 billion, far exceeding any of Beijing's other bilateral trade relationships.

Japan also sought to offer reassurances to China at a political level. In August, Noboru Takeshita made his first visit to China as Prime Minister. Takeshita's visit was a distinct success, especially given that Japan extended a major new low-interest loan for the 1990-95 period, totaling more than \$6 billion. But China also continued to press for increased Japanese direct investment and additional technology transfer.

The other major diplomatic event of the year was the visit of Indian Prime Minister Rajiv Gandhi in December, the first such visit in nearly 35 years. Sino-Indian relations had been severely estranged since the late 1950s, but especially since 1962, when the two sides fought a border war. Although the visit was more atmospheric than substantive, the symbolic importance of Gandhi's visit was considerable, and both sides deemed the trip a major success.

Breakthroughs of a different sort were achieved in relations with South Korea. Although the absence of formal diplomatic relations with Seoul placed obvious limits on the scope of these ties, contacts in the past year grew appreciably. China sent a large contingent to the Summer Olympics in Seoul, and two-way trade for 1988 was expected to approach \$3 billion. At the same time, China indicated its readiness to facilitate South Korean investment in China and other forms of direct commercial contacts that were unthinkable only a few years ago.

TAIWAN

1988 proved a year of extraordinary political change on Taiwan. The death of long-time leader Chiang Ching-kuo in January aroused concerns about a potential succession struggle in the upper reaches of the Kuomintang (Nationalist Party). The smooth transition to top leadership by Li Teng-hui, an American-trained Ph.D. and a Taiwanese native, laid these concerns largely to rest. Li's immediate elevation to the Presidency and his subsequent election to leadership of the party during the Kuomintang's 13th Party Congress reflected Li's substantial political abilities and a much surer grasp of political power than many observers had predicted.

Li Teng-hui moved with unexpected speed to revamp the Kuomintang leadership structure. In a major cabinet reorganization in July, 15 newcomers were promoted into the 22-member body, with native Taiwanese (who represent 85 percent of the island's population) holding a majority of the positions for the first time. Although some of the appointments reflected Li's continuing need to balance reformists and conservatives in leadership slots, the predominant thrust was toward reform-oriented politicians, most with advanced academic background. The cabinet also included its first woman member.

Li Teng-hui's elevation to the Presidency had followed closely behind the late Chiang Ching-kuo's initiation of political reform on Taiwan. In the space of only several years, the island's politics had under-gone a remarkable transformation, with past restrictions on political activity (including the sanctioning of a formal political opposition and an increasingly vibrant press) largely removed. These trends included important changes in Taiwan's mainland policy. Although the Kuomintang repeatedly insisted that it would refuse any direct contact or negotiations with the Communist Party of China (CPC), this policy did not preclude other dealings. These relations included indirect trade that was expected to exceed \$2 billion in 1988, limited direct investment by Taiwanese businessmen in China's coastal provinces, and an increasing range of contacts and exchanges between citizens of both regimes. Perhaps the most dramatic development was the flow of

visitors from Taiwan to the mainland. Since the change in the mainland visitation policy was announced in late 1987, more than 300,000 Taiwanese citizens had visited the mainland.

At the same time, however, the Kuomintang leadership sought to maintain firm control over any dealings with the CPC, and continued to reject all appeals from Beijing for direct, official contact between the two ruling parties. During a mainland visit in October, senior Kuomintang legislator Hu Ch'iu-yuan held unauthorized meetings with senior Chinese officials, leading to his immediate expulsion from the Party. Although the Kuomintang leadership continued to explore options for additional steps in its indirect dealings with Beijing, Li Teng-hui clearly preferred that these measures be undertaken on a step-by-step basis.

The leadership in Taipei also reiterated its determination to maintain a substantial, technologically advanced military capability. In December, after years of effort and the expenditure of more than \$1 billion in development costs, Taiwan unveiled the prototype of its indigenous defense fighter (IDF), the aircraft intended to replace aging American planes in Taipei's defense inventory. Plans to build approximately 250 of these aircraft and related measures to upgrade Taiwan's naval capabilities suggested that there would be no slackening of the island's defense readiness.

Taiwan's longer-term health also continued to rest on its vibrant economy. Over the past several decades, Taiwan had sustained one of the highest economic growth rates in the world. Economic growth for the year was projected at 7.06 percent, a decline from 1987's double-digit growth but still very robust. Per capita income was expected to surpass \$6,000, bespeaking Taiwan's rapid advance to modernity. The steady increase in income, much of it as a consequence of export-led growth, was manifested in foreign exchange reserves of approximately \$75 billion, an amount exceeded only by those of Japan.

Taiwan was also under increasing pressure to reduce its huge trade advantage, especially with the United States, its leading trading partner. As a result of a number of "buy America" missions and the

stimulation of domestic consumption, Taiwan's trade surplus with the United States dropped from \$19 billion in 1987 to \$14 billion in 1988. Continued pressures from the United States to further reduce the deficit and provisions of U.S. trade legislation that Taipei deemed protectionist clouded the longer-term economic picture.